which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.

(9) *Effective date*. This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002. Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), *Example 2*, *Example 5*, *Example 7*, *Example 8*, and *Example 9* of this section are effective on *August 14, 2008*.

[T.D. 8419, 57 FR 22649, May 29, 1992; 57 FR 28613, June 26, 1992, as amended by T.D. 8600, 60 FR 37581, July 21, 1995; 60 FR 49976, Sept. 27, 1995; 60 FR 58234, Nov. 27, 1995; 61 FR 2869, Jan. 29, 1996; T.D. 8869, 65 FR 3849, Jan. 25, 2000; T.D. 8940, 66 FR 9929, 9957, Feb. 13, 2001; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9078, 68 FR 42252, July 17, 2003; T.D. 9422, 73 FR 47527, Aug. 14, 2008]

§ 1.1361–2 Definitions relating to S corporation subsidiaries.

(a) *In general*. The term *qualified subchapter S subsidiary* (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSub under § 1.1361–3.

(b) *Stock treated as held by S corporation*. For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section—

(1) Stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor*. Section 1.1361–1(l)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361–1(l)(5) if issued by the S corporation.

(d) *Examples*. The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of Y, a corporation for which a valid QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub under section 1361(b)(3)(B)(ii).

Example 2. Assume the same facts as in *Example 1*, except that Y is a business entity that is disregarded as an entity separate from its owner under § 301.7701–2(c)(2) of this chapter. X may elect to treat Z as a QSub.

Example 3. Assume the same facts as in *Example 1*, except that Y owns 50 percent of Z, and X owns the other 50 percent. X may elect to treat Z as a QSub.

Example 4. Assume the same facts as in *Example 1*, except that Y is a C corporation. Although Y is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for Y. Thus, X is not treated as holding the stock of Z. Consequently, X may not elect to treat Z as a QSub.

Example 5. Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361–1(l)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding stock. In addition, under § 1.1361–1(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361–1(l)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.

[T.D. 8869, 65 FR 3849, Jan. 25, 2000]

§ 1.1361–3 QSub election.

(a) *Time and manner of making election*—(1) *In general*. The corporation for which the QSub election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

(2) *Manner of making election*. Except as provided in section 1361(b)(3)(D) and

§ 1.1361–5(c) (five-year prohibition on re-election), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the IRS. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037. Unless the election form provides otherwise, the election must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable), and, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should be submitted to the service center where the S corporation filed its most recent return.

(3) *Time of making election.* A QSub election may be made by the S corporation parent at any time during the taxable year.

(4) *Effective date of election.* A QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term *month* found in § 1.1362–6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(5) *Example.* The following example illustrates the application of paragraph (a)(4) of this section:

Example. X has been a calendar year S corporation engaged in a trade or business for several years. X acquires the stock of Y, a calendar year C corporation, on April 1, 2002. On August 10, 2002, X makes an election to treat Y as a QSub. Unless otherwise specified on the election form, the election will be effective as of August 10, 2002. If specified on the election form, the election may be effective on some other date that is not more than two months and 15 days prior to August 10, 2002, and not more than 12 months after August 10, 2002.

(6) *Extension of time for making a QSub election.* An extension of time to make a QSub election may be available under the procedures applicable under §§ 301.9100–1 and 301.9100–3 of this chapter.

(b) *Revocation of QSub election*—(1) *Manner of revoking QSub election.* An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation.* The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

(3) *Revocation after termination.* A revocation may not be made after the occurrence of an event that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(4) *Revocation before QSub election effective.* For purposes of Section 1361(b)(3)(D) and § 1.1361–5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be

treated as a termination of a QSub election.

[T.D. 8869, 65 FR 3850, Jan. 25, 2000]

§ 1.1361–4 Effect of QSub election.

(a) *Separate existence ignored*—(1) *In general*. Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), (a)(8), and (a)(9) of this section, for Federal tax purposes—

(i) A corporation that is a QSub shall not be treated as a separate corporation; and

(ii) All assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

(2) *Liquidation of subsidiary*—(i) *In general*. If an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the transfer of assets to the subsidiary and the deemed liquidation are disregarded, and the corporation will be deemed to be a QSub from its inception.

(ii) *Examples*. The following examples illustrate the application of this paragraph (a)(2)(i) of this section:

Example 1. Corporation X acquires all of the outstanding stock of solvent corporation Y from an unrelated individual for cash and short-term notes. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. Because X acquired all of the stock of Y in a qualified stock purchase within the meaning of section 338(d)(3), the liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337.

Example 2. Corporation X, pursuant to a plan, acquires all of the outstanding stock of corporation Y from the shareholders of Y solely in exchange for 10 percent of the voting stock of X. Prior to the transaction, Y and its shareholders are unrelated to X. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. The transaction is a reorganization described in section 368(a)(1)(C), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied.

Example 3. After the expiration of the transition period provided in paragraph (a)(5)(i) of this section, individual A, pursuant to a plan, contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction is a reorganization under section 368(a)(1)(D), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied. If the sum of the amount of liabilities of Y treated as assumed by X exceeds the total of the adjusted basis of the property of Y, then section 357(c) applies and such excess is considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(iii) *Adoption of plan of liquidation*. For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the QSub election is adopted on an earlier date, the making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (a)(2)(i) of this section.

(iv) *Example*. The following example illustrates the application of paragraph (a)(2)(iii) of this section:

Example. Corporation X owns 75 percent of a solvent corporation Y, and individual A owns the remaining 25 percent of Y. As part of a plan to make a QSub election for Y, X causes Y to redeem A's 25 percent interest on June 1 for cash and makes a QSub election for Y effective on June 3. The making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation. The deemed liquidation satisfies the requirements of section 332.

(v) *Stock ownership requirements of section 332*. The deemed exercise of an option under §1.1504–4 and any instruments, obligations, or arrangements that are not considered stock under